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IN THE

# Supreme Court of the United States

OCTOBER TERM, 1971

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| MOBIL OIL CORPORATION, Petitioner, vs. CARL F. MATZEN, et al., Respondents. | No. 71-1169 |
| AMOCO PRODUCTION COMPANY, Petitioner, vs. LELAND C. WAECHTER, et. al., and THE LAND AND ROYALTY OWNERS OF LOUISIANA, Respondents. | No. 71-1179 |
| CITIES SERVICE OIL CO., Petitioner, vs. CARL F. MATZEN, et al., Respondents. | No. 71-1188 |
| SHELL OIL COMPANY, Petitioner, vs. CARL F. MATZEN, et al., Respondents. | No. 71-1191 |
| FEDERAL POWER COMMISSION, Petitioners, vs. MOBIL OIL CORPORATION, et al., Respondents. | No. 71-1326 |

## BRIEF IN OPPOSITION FOR RESPONDENTS CARL F. MATZEN, et. al. and LELAND C. WAECHTER, et. al.

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## BRIEF IN OPPOSITION FOR RESPONDENTS CARL F. MATZEN, et. al. and LELAND C. WAECHTER, et. al.

Mobil Oil Corporation, Amoco Production Company and their supporting intervenors, Cities Service Oil Company and Shell Oil Company, have petitioned for certiorari. They were subsequently joined by the Federal Power Commission. These Respondents oppose.

## QUESTION PRESENTED

The question is solely one of law, which can be fairly stated as follows:

Is a landowner a natural-gas company under the Natural Gas Act and are the amounts of monthly cash rental payments due to him under a mining lease subject to regulation by the Federal Power Commission if the lease permits lessee to use the leased premises for the purpose of manufacturing, mining, producing, saving and taking care of natural gas in commercial quantities thereon with an obligation to compute such cash rental payments as royalty, and the lessee, after such use, sells to others for its own account the natural gas so produced (owned solely by it as produced by it) for resale in interstate commerce?

## STATEMENT OF THE CASE

The facts are undisputed.

Unfortunately, they are largely obscured in the petitions for certiorari. Because the Commission, made up of both lawyers and laymen, had no expertise as a body regarding the applicability of the facts to common law rules, it sought and received evidence regarding the state of the law, and the state of the law turned out to be undisputed.

The following statement therefore includes a summary of undisputed evidence regarding common law principles universally applicable governing the lessor-lessee

relationship involved. If this statement appears to be contrary to assertions made in the petitions, it is not because they are disputed but because of a certain ambivalence, only a few instances of which we will bother to point out as illustrative in footnotes as we go along.

## Description of Parties, Leases, Leasehold and Marketing Activities

Each of these respondents, Carl F. Matzen, et al. and Leland C. Waechter, et al., is the owner of a tract of farm land in Western Kansas or a part thereof. The tracts vary in size, but the majority contain 160 acres. Each owner's interest is burdened by an oil and gas lease.

The leases vary in their language, but are conventional in form and include provisions of which the following can be described as fairly typical:

> "1. That lessor, for and in consideration of the sum of _____ Dollars ($_____), in hand paid, and of the covenants and agreements hereinafter contained to be performed by the *lessee* has this day granted and *leased* and hereby *grants leases* and *lets* unto the *lessee for the purpose of mining* and *operating* for and *producing* oil and gas, casinghead gasoline, laying pipe lines, building tanks, storing oil, building powers, stations, telephone lines and other structures thereon to produce, save, take care of and *manufacture all of such substances*, and for housing and boarding employees, . . ."
>
> "2. This lease shall remain in force for a term ending _____, and as long thereafter as oil, gas, casing-

head gas, casinghead gasoline, or any of them is produced."

* * *

"4. The lessee shall monthly pay lessor as royalty on gas marketed from each well where gas only is found, one-eighth (⅛) of the proceeds if sold at the well, or if marketed by lessee off the leased premises, then one-eighth (⅛) of its market value at the well .... Lessor shall have the privilege at his own risk and expense of using gas from any gas well on said land for stoves and inside lights in the principal swelling located on the leased premises by making his own connection thereto.

"Where gas from a well or wells, capable of producing gas only, is not sold or used for a period of one year, lessee shall pay or tender as royalty, an amount equal to the delay rental as provided in paragraph (5) hereof, payable annually at the end of each year during which such gas is not sold or used, and while said royalty is so paid or tendered this lease shall be held as a producing property under paragraph numbered two hereof."

"5. If operations for the drilling of a well for oil or gas on said land or for gas, on a consolidated leasehold estate of which this land is a part thereof, as contemplated in paragraph 9, are not commenced on or before _____ this lease shall terminate as to both parties unless the lessee shall on or before that date, pay or tender to the lessor, or to the lessor's credit in the _____ Bank at _____, or its successors, which bank and its successors are the

lessor's agent and shall continue as the depository of any and all sums payable under this lease, regardless of changes of ownership in said land or in the oil and gas, or in the rentals to accrue thereunder, the sum of _____ Dollars ($_____), which shall operate as rental and cover the privilege of deferring the commencement of drilling operations for a period of one year. In like manner and upon like payments or tenders, the commencement of drilling operations may be further deferred for like periods successively . . . ." (Ex. 4, R. 1152, Italics added)

Among the owners of such leases are petitioners Mobil Oil Corporation, Amoco Production Company and Cities Service Oil Company.

Leasehold operations were conducted on the leased premises by the respective lessees. Such activities eventually included natural gas production activities in the Kansas Hugoton Gas Field area through lessees' use of the land and wells drilled by them thereon.

The lessees were and are the first owners of all the natural gas they produce, as produced by them. In some instances the lessee had assigned leasehold interests to others, such as lease brokers or farmoutees. (For typical instruments see R. 1984-2010). Such lease assignments carried with them, or reserved in lessee, a fractional co-ownership interest in and to the natural gas as and when produced. Such ownership interest in natural gas is sometimes referred to as an overriding "royalty interest". (R. 1946)

The lessors themselves neither have nor retain nor obtain such ownership[1] or royalty interest[2] in the natural gas production. They have no natural gas or co-ownership interest therein to sell.[3] (Court of Appeals, Opinion, Shell Pet.; p. 9a-11a).

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1 Mobil, on page 3 of its petition, states:

"Under state law, the various interests in the *total volume* delivered from a given well are classified principally as 'working' interests and as 'royalty' interests." As related to gas production involved in these cases, the statement is incorrect. We are confident this must have been unintentional. The interests mentioned could be more fairly described as interests in *leases*. They certainly cannot be described as interests in volumes of natural gas. Mobil then states that the working interest owner is the lessee and goes on to describe the lessor royalty interest in terms of a "percentage or fraction (e.g., 1/8)". From these references it might be inferred that the owners of the so-called working interest in the leases in question (the lessees) own a part of the volumes of natural gas delivered from a well, while the owners of the so-called royalty interest in the leases (the lessors) at some time own the other part of such volume. We are confident that Mobil must not have intended to create this impression, since it is admitted that this is not and has never been true. (A similar, erroneous inference is created on pages 7 and 8 in Mobil's petition with reference to certificate and rate filings.)

2 Cities Service, Amoco and Cities in stating the question presented, and all petitioners elsewhere, refer to respondents' royalty interests *in natural gas*. They thus identify the interests of landowners with the overriding "royalty interests" of assignees from the lessee, above described. These royalty assignees of lessee, along with the lessee itself, are the only ones who have an ownership interest in the gas. They do not include the landowner-lessors. We feel confident that such use of words was not designed to confuse the Court. Nor is Mobil's inference in its footnote on page 6 of its petition, which could suggest that respondents are not lessors and part-owners of the leased premises.

3 Mobil describes a "division order" as certifying lessors' "interest in natural gas delivered under rates schedules on file with the Federal Power Commission." (Mobil Pet., 7) Mobil surely did not intend to suggest that the landowner has any legal or equitable, possessory or non-possessory, interest in natural gas so to certify or that any such so-called "division order" refers to anything but cash amounts due as rental compensation to be made in accordance with the lease terms, and not as a division of volumes sold. (R. 1957-8)

The lessees and their assigns use and market the commodity solely on their own account under a variety of arrangements, eventually marketing the same in three states of matter — gaseous, liquid and solid. (R. 2049)

That part marketed (or used) by lessee in gaseous state not lost in transmission is sold by the lessee and its assigns to pipelines for resale in interstate commerce or is used by lessee as fuel in compressor stations, or is sold for other local purposes prior to delivery of the residue to the pipelines.

That portion marketed in liquid state (which is a part of a gaseous volume when produced) results from use of the natural gas by the lessee off the leased premises in removing valuable hydrocarbons which become liquefied (such as propanes, butanes and natural gasolines), which are then marketed by lessee off the leased premises, with only the residue gas remaining being delivered in gaseous state to pipeline companies. (R. 2030, 2040-2042)

The part marketed in solid state results from another use by lessee or an affiliate of the natural gas off the leased premises. That part is sold as carbon black, a residual of the combustion of the natural gas in facilities built for that purpose, marketed off the leased premises. (R. 2049)

All leasehold and marketing activities are carried out by the lessee and its assigns on their own account without any participation by the lessor. Lessor had no

"say" and no right to have a "say" regarding marketing. He had no role to play and played no role. His only relevant activity was signing the lease which gives him no rights regarding marketing (R. 1152, 1153). If he was curious, he tried to find out, if he could, what was going on, on his own land, and what was happening to the natural gas after production. (Much of such information is learned after a suit is filed.)

The lease typically gives lessee the privilege of using gas free of charge from any gas well in the principal dwelling house on the particular leased premises. If landowner-lessor wants to use the gas for any other purpose, such as for fuel to power irrigation pumps on the very leased premises, he is in the position of a complete stranger, — he must negotiate at arms-length, if he can, a separate purchase contract with his own lessee for the sale of the natural gas to him.

The lessee is obligated under the particular leases in question to pay the monthly rental computed as royalty, in *cash* and *not in kind*. Such payments are in amounts based on the amount of production each month. They are further related to a value factor described by use of words such as "market value", "market price", "wellhead value", "proceeds", etc.[4] Distinctions are made based on the various places and methods of marketing or uses to which the lessee puts the gas, the relevant value usually being on the leased premises and not at a place of delivery away

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4 Shell pet., 35a-36a

therefrom after gathering, liquid extraction, etc.[5] (R. 1152, 1153)

As a result of the cash payment requirement and the various possible marketing conditions, the royalty is computed based upon *a percentage of the value* of the entire quantity commercially produced each month rather than upon the value of a *percentage of the production.*

Under the leases in question, the percentage is one-eighth. The leases refer to one-eighth of the appropriate value factor. None of them refer to one-eighth of the amount produced. (R. 1152, 1153)

## Nature of Disputes Between Lessor and Lessee and Resulting Litigation

Disputes arose between the landowners and lease owners as to the amount of royalty payments which had become due each month by reason of production activities by lessee over a past period of months. They finally resulted in traditional lawsuits brought by landowner-lessors in Western Kansas in 1963 through 1965.

The litigation was of the same nature as litigation which has been going on for over a century between other landowner-lessors and their oil and gas lessees.

The nature and extent of such litigated dispures is revealed by the summary of the controversies with Amoco and Mobil which follows.

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5 Sometimes a proceeds-less-expense formula is used to arrive at a value on the leased premises when the gas is used and marketed off the leased premises in both liquid and gaseous state. See, for example, *Matzen v. Hugoton Production Company,* 182 Kan. 456, 321 P.2d 576 (1958)

Amoco as lessee beginning in 1954 made monthly payments amounting to .9375 cents per Mcf of the gas produced up to 1.5 cents per Mcf including 1.34 cents and 1.375 cents, plus in many instances (and in those instances with respect to each varying figure above mentioned) small additional payments by reason of an incremental value on the leased premises of liquefiable hydrocarbon content marketed by it off the leased premises through its own use of the produced gas (R. 2023-2026, 2030, 2053)[6] Amoco had, part of the time, computed its base payments through the use of a uniform per Mcf figure and all of the rest of the time by using varying per Mcf figures during each month, depending on whether the part of the natural gas sold in gaseous state was sold by it or was sold by its farmoutees (co-owners of the gas with it by reason of assignment of working interests in the leases) with the figures varying part of the time within the limits above mentioned depending upon which of its co-owners sold such produced gas and upon their proportionate ownership. (R. 2022-2030)

In 1963 Amoco began to withhold from the landowners' monthly compensation so variously computed by it as currently due, amounts it claimed it had overpaid during monthly periods nine years before that time. (R. 2022-24)

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6 All amounts are stated in the section based on values of per thousand cubic feet (Mcf) of all gas produced, at a pressure of 14.65 pounds per square inch absolute, with equivalent values stated where measurement is on another pressure basis.

The landowners asserted claims for additional amounts by reason of production after June of 1961 only, claiming that Amoco was obligated as primary and base lessee to assure monthly rental payments after that time based on a uniform value on the leased premises of 1.8125 cents per Mcf of all gas produced (regardless of such differing percentages of ownership in others), in addition to the incremental value by reason of the liquefiable hydrocarbon content separately marketed off the leased premises. They also resisted Amoco's affirmative claims of right of offset for alleged overpayments made during past months. (R. 2040-1)

Mobil, with respect to one group of leases, beginning in 1954 paid royalties amounting to 1.375 cents per Mcf produced, later reduced to a little over one-half of a cent per Mcf then increased to something below one cent per Mcf and later further increased to 1.375 cents per Mcf. In the latter part of 1965 Mobil first began to pay small additional incremental amounts by reason of the enhanced wellhead value of all of the gas produced by reason of its liquefiable hydrocarbon content separated and marketed by it off the leased premises. (R. 2039, 2024, 2040)

Additional adjustments in past payments were also made after the landowners filed suit when it was discovered that, notwithstanding the removal of liquids, shrinkage and fuel used in plants, Mobil had been selling more residue gas than the monthly amounts it had theretofore reported that it was producing. (R. 2041)

In December of 1964 it began withholding from current monthly payments, computed as above stated, amounts it claimed it had overpaid in months ten years before that time. (R. 2040)

The landowners claimed that Mobil was contractually obligated in recent years to make monthly payments amounting to about two cents per Mcf by reason of its production of all gas whether marketed by Mobil in gaseous or liquid state, compared with Mobil's claims that it was obligated over the period involved to make payments amounting to a little over 1.375 cents per Mcf produced in addition to varying small incremental monthly amounts by reason of the value on the leased premises of the liquefiable content removed and marketed by it through its use of the gas off the leased premises. (A. 2040-1, 2048)

With respect to a second group of leases, beginning in 1954 Mobil made payments amounting to 1.375 cents per Mcf with a reduction in 1957 to less than a penny. After suit was filed against it, it tendered a retroactive payment into court of additional amounts designed to make total payments amounting to 2.093 cents per Mcf for one period, down to 1.375 cents per Mcf for a later period, back up to 2.093 cents per Mcf for a still later period, and back down to 1.375 cents per Mcf. (R. 2045)

From the amount otherwise due under this retroactive adjustment, it deducted sums which it claimed to be due to it for alleged overpayments made for months many years before, when it was making payments amounting to 1.375 cents per Mcf, thus unilaterally recovering everything it

had paid except that amounting to less than a cent per Mcf. (R. 2045-6)

As to a third group of leases, Mobil made royalty payments amounting to 1.375 cents per Mcf produced for a period of time and then reduced payments so that they would amount to less than a penny per Mcf produced. (R. 2049) After suit was filed and in March of 1965 it tendered into court a purported retroactive accounting for additional royalties. The basis of payment for the adjustments was such as to result in total payments amounting to 1.875 cents for one period, decreased to 1.375 cents for a later period, increased back up to 1.875 cents for a still later period, and decreased back down to 1.357 cents thereafter, with Mobil withholding, in connection with such tender, amounts claimed due to it for earlier months. (R. 2049, 2047)

As to the second group of Mobil leases, landowners claimed that since December 1, 1958, they had been entitled to payments amounting to 2.093 cents per Mcf. produced and as to the third group of Mobil leases that they had been entitled to payments amounting to 1.875 cents per Mcf. produced, in both instances resisting Mobil's claims of a right of offset as to overpayments allegedly made during many months before that. (R. 2043-2049)

In summary, leases claimed that monthly royalties should be paid at figures since 1954 amounting to about a half cent per Mcf. produced to over two cents during later periods, with the landowners claiming that payments

amounting to a little over two cents per Mcf. should have been made consistently during later months.

The lessees engaged in motion practice, vigorously asserting what appeared to be every possible traditional defense. Landowners began filing individual suits. Because of the relatively small amounts for each landowner as compared with the great array of legal, technical and expert resources available to these major oil companies (a full allowable for one well is based upon 640 acres), groups of landowners attempted to change their actions into class actions and began filing class actions in the first instance. This was resisted by lessees and no class orders were or ever have been entered in the cases. (For representative state court pleadings, see R. 2021-2050, 1545, 2052, 2064, 2124, 2130, 2137, 2145, 2155, 2157, 2159, 2170, 2181, 2183, 2185, 2189, 1544-1559, 1561-1563, 1567-1571, 1151, 1154, 1855-1863)

**Proceedings Before the F.P.C. and Review Thereof**

Before any determination as to any substantive issue could be made, lessees seized upon an entirely new strategm. In 1967, Mobil and Amoco suddenly brought complaint proceedings against the landowners before the Federal Power Commission and Cities Service intervened. Each complaint was brought by a lessee against all of the landowners with whom it had such a dispute. In such complaints the lessees claimed, for the first time, that the respondents were natural-gas companies under the Natural Gas Act and that the amount of such monthly payments due to them

as lessors from the lessees were subject to direct regulation by the F.P.C. They also claimed that the landowners were violating the Natural Gas Act in seeking traditional judicial remedies to recover the contractual monthly amounts alleged to be owing to them under the leases.

The state court judicial proceedings were then stayed by federal court order at the instance of lessees and the landowners were required to go to the nation's capital, where they were introduced for the first time to the strange and baffling mysteries of expensive and lengthy administrative proceedings before the Federal Power Commission.

The respondents had theretofore been complete strangers to Commission regulation. They had never been parties to any proceedings before the Commission. They had not made or been required or notified to make any filings or appearances of any kind before the Commission.

The Commission was equally unfamiliar with landowners and leases. It had never considered disputes between such lessors and lessees. The Commission had no expertise as a body in this area, being unfamiliar with the lessor-lessee relationship. It affirmatively requested and received evidence as to the legal nature of the oil and gas leases and their economic consequences, above described.

The complaint proceedings were consolidated with somewhat similar proceedings previously filed by others,[7] and a divided Commission, by a 3-2 majority, found and held in the order on review[8] that the landowners were

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7 Resulting from the case of *J. M. Huber Corp. v. Denman*, 367 F.2d 104 (1966), Shell pet., 88a

8 Shell pet., 27a-40a

natural-gas companies, that the lease provisions requiring such periodic royalty payments constitute "sales" for resale in interstate commerce under the Natural Gas Act, and provided for implementation of its asserted jurisdiction in an attempt to regulate the amount of such payments retroactively to 1954.[9]

In its opinion, the Commission isolated out of the integrated lease that single portion containing the particular royalty formula.[10] It then isolated out of the royalty formula the particular words referring to the value of the gas, described by it as "proceeds", "market value", "market price", "wellhead value", etc.[11] It held it had jurisdiction over such isolated words for the reason that they resulted in a payment "based upon the production of natural gas in interstate commerce."[12] It found the "basic fact" to be "the effective retention by the royalty holders of a percentage interest in the gas sold in interstate commerce."[13] It held that whether "under private law"[14] the lessors ever had a legal or equitable, possessory or non-possessory, interest in such commodity first owned and sold by lessee and its assigns was not determinative.

It thus justified its departure from long established law on the basis of its description of such lease rental provision as an arrangement under which the lessor "retained" an *economic interest* in interstate sales sufficient

9 Shell pet., 39a-40a
10 Shell pet., 35a
11 Shell pet. 35a-36a
12 Shell pet., 36a
13 Shell pet., 34a
14 Shell pet., 35a

to describe that particular lease rental transaction as a "sale".

Various judicial review proceedings instituted by both sides were consolidated in the United States Court of Appeals for the District of Columbia Circuit. That Court, in a carefully reasoned unanimous decision[15] reversed on the grounds that neither the statutory language nor congressional intent justified such an attempt to extend the jurisdiction of the Commission.

## REASONS FOR DENYING THE WRITS

This case involves only private contract disputes between landowners and their major oil company lessees. The lessees seek to avoid paying rent they agreed to pay many years ago. They conceived of the Commission's legitimate concern for the ultimate consumer as a possible instrumentality to achieve their purpose of enhancing their own profits. They convinced a majority of a sharply divided Commission that a century of real estate law could be obliterated by turning a rental transaction into a sale of a commodity on the theory that Congress in 1938 sought to protect the consumers from being exploited by farmers.

Some added scheme was necessary also to create additionally, out of thin air, a regulated "rate" for the pretended "sale". They therefore suggested that the Commission accept a loan for this purpose of their own service rate filings covering a different "sale" (an actual one) of natural gas made by them and their co-owners to

15 Shell pet., 1a-26a

others. The result was an attempt to make the landowners the only regulated persons in the history of our nation whose "rates" would be regulated, not by any examination of the economic impact upon them of the regulation, but solely by reference to the expenses, profits, investments, facilities, contracts, risks, tariffs, costs and allowed returns of other persons engaged in a completely different business. The sought-for order, in effect, ignored all of the provisions of the Natural Gas Act, except the word "sale", and all rules and regulations of the Commission thereunder.

But this flagrant attempt to misuse administrative regulation has not survived judicial scrutiny. The result reached by the Court of Appeals is so obviously correct that this Court should not be burdened with its consideration. The result could only be further delay with many more landowners joining the many who have already died since the state court suits were filed.

## ARGUMENT

### This Case Involves No Unusual or Substantial Question of National Concern

This case involves private contract disputes. Recovery by landowners of any additional royalty would affect the companies' stockholders only. The first sale in interstate commerce was and is already 100%, regulated as to 100% of the natural gas sold in interstate commerce, with no gap in regulation. F.P.C. jurisdiction is complete, the rates are fixed and the consumers protected.

The lease rental payments to landowners fall in the same category as rental payments on the companies' offices, wages paid to executives and drilling crews, and all other payments made by the lessees in connection with the production of natural gas. All of such costs result from agreements between the lessee and unregulated third-parties.

The Commission's theory of "economic benefit" to the lessor applies equally to all persons who derive economic benefit by being paid for goods or services furnished to them by lessees by reason of and in connection with the existence of its gas production activities.

In each instance a bargain is struck between the lessee and the person furnishing the land rented, the goods supplied or the services performed. That bargain is allowed to govern subject to the power of the Commission, in fixing producer rates, to determine the reasonableness of such costs not directly subject to its regulation.

The distinctions sought to be made between a situation where a flat sum is paid and one where it is based on a percentage is spurious.

In entering into rental agreements, the rental is always based upon what the parties feel is the use-value of the land. In the case of mining leases, that value is difficult to provide for and to measure when provided for. This means that, unlike similar provisions in other percentage leases based solely on net income, profits, etc.,

the mathematical formula in the gas lease requires the use of percentage factors relating to values not necessarily reflected by direct figures on lessee's books of account.

This case is here only because such use-value was disputed under the variety of marketing arrangements above described, the lessees unilaterally made judgment decisions as to what values they would use from time to time in computing and tendering payments — they are not billed by the lessors — litigation resulted regarding the proper amount of rental payments, and the lessors committed *lese majesty* against lessees in attempting to unite and use a judicial class action remedy hopefully available in recent years.

The existence of lawsuits resulting from such traditional disputes is of no more legal significance in the light of the Natural Gas Act than any other dispute involving expenditures of a lessee-producer.

This case does not present anything of national significance more than would be presented by any other dispute which the lessee would have concerning the amount owed by it to third-parties who furnish the resources which enable it to carry on its natural gas production activities.

These companies obviously paid landowner-lessors as little as they thought they could get by with. When challenged, they joined together in massively resisting the effort to get them to pay their debts. And they coercively

suggest that the recent possibility of landowners' use of class actions justifies transforming landowners into proper subjects of administrative regulation, thus attempting to avoid defenses for judicial determination. A more straightforward approach would be to frankly attempt explicitly to exempt major oil companies from the judicial rules providing for class actions.

As stated by Commissioner O'Conner in his dissent:

> ". . . I believe our jurisdiction of the lessee-producers is sufficient in and of itself to guarantee "an adequate supply at the lowest reasonable rates." The point I want to make very clear is that in my opinion the consumer will not suffer from a higher price by not regulating the amount the producer will pay to the royalty owner. This price paid by the producer to the royalty owners falls in the same category as the wages paid to his drilling crews, and the price he pays for the pipe he sinks into the ground." (Shell pet., 61a).

**The Decision Below Is Correct**

The opinion of the Court of Appeals is obviously carefully thought out, reaches the correct result and faithfully follows all previous decisions of this Court.

Section 1(b) of the Natural Gas Act states the full extent of its applicability:

> "The provisions of this chapter shall apply to the transportation of natural gas in interstate commerce, to the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial or any other use, and to natural-gas companies engaged in such transportation of sale,

but shall not apply to any other transportation or sale of natural gas or to the local distribution of natural gas or to the facilities used for such distribution or to the production or gathering of natural gas." 52 Stat. 821 (1938), 15 U.S.C. 717 (b)

Section 2(6) (Definitions) defines a "natural gas company" as:

"'Natural Gas Company' means a person engaged in the transportation of natural gas in interstate commerce, or the sale in interstate commerce of such gas for resale." 52 Stat. 821 (1938), 15 U.S.C. 717a (6)

No more explicit statement of the scope of the Act could be made than that set forth by this Court in *Panhandle Eastern Pipeline Co. v. Public Service Commission*, 332 U.S. 508, 516 (1947):

"... Three things and three only Congress drew within its own regulatory power, delegated by the Act to its agent, the Federal Power Commission. These were: (1) the transportation of natural gas in interstate commerce; (2) its sale in interstate commerce for resale; and (3) natural gas companies engaged in such transportation or sale. ..."

No claim is made that respondents transport natural gas or are engaged in its transportation. Accordingly, respondents are subject to regulation only if they sell gas in interstate commerce for resale.

There is no indication anywhere that Congress did not have in mind the ordinary, usual and natural sense of the word "sale" when the Act was passed thirty-five years ago. And, as was pointed out by the Court of Appeals in

the decision below,[16] this would be particularly true because "sale" is not one of the terms for which Congress provided an express or supplemental definition in the portion of the Act, 15 U.S.C. Sec. 717a (Definitions), defining terms.

This Court, in cases before the enactment of the Natural Gas Act, described the production activities carried on by lessees as purely local mining and manufacturing operations carried on by use of the soil whereby a commodity which did not previously exist is created by lessee. *Champlain Refining Co. v. Corporation Commission*, 286 U.S. 210, 235 (1932); *West v. Kansas Natural Gas. Co.*, 221 U.S. 229, 255-256 (1910); *Burnet v. Harmel*, 287 U.S. 103, 107 (1932). As the Court below pointed out,[17] this Court in the *Burnet* case observed the lack of incidents of a "sale" by a landowner-lessor under an oil and gas lease, both in technical terms and common understanding.

It is beyond dispute that courts have universally defined the payment of lessor royalty to landowner as payment for the use of his property in the nature of rental.

Nor is there anything else which shows the intent of Congress in 1938 to include such rental transactions within the meaning of the word "sales", or to include the fragmentated activities of the embattled dust-blown farmers of Western Kansas within the definition of a natural gas company. The 1938 Act was based upon Federal Trade Commission reports.[18] Certainly the thousands of farmers

16 Shell pet., 9a
17 Shell pet., 10a-11a
18 52 Stat. 821 (1938), 15 U.S.C. Sec. 717a

of this country were not included within the "handful of holding companies" who created the "specific evils" found by that Commission to exist and to which Congress addressed itself. See *F.P.C. v. Hope Natural Gas Co.*, 320 U.S. 591, 610 (1944).

The intent of Congress is also clearly demonstrated by the fact that all other language in the Act, in addition to the word "sale", is incomprehensible if sought to be applied to landowners and leases. As the Commission found out when it attempted to shoe-horn the landowners into the Act at the behest of the oil company lessees, there is no language in the Act that anybody (except an administrative body regulating to protect the regulated) can apply with a straight face to landowners or their leases. The language of the Act makes absolutely no sense when an attempt is made to apply it to landowners.

The Commission ran into the problem at the outset. Section 4(c) of the Act, 15 U.S.C. Sec 717(c),[19] requires that every natural gas company" file with the Commission within 60 days of the date of the Act in such form as the Commission may prescribe[20] and keep open in convenient

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19 Mobil App., 109

20 The Commission has never made any rules or regulations relating to landowners or leases. The producer regulations are effectively limited in language to apply only to lessee and his assigns (including over-riding royalty interest owners), *who are co-owners of the natural gas*. Lessees have filed lists of the names and percentage of ownership of everyone whose natural gas is being delivered under the rate filings made by lessees. They have covered 100% of the gas. They have not purported to name any landowner or cover any interest presumed to belong to him, nor has the Commission ever suggested they should. Nor does it now so suggest. Those same regulations require the filing of some document authorizing the operator to sell the gas belonging to the co-owners. Yet nobody has filed an oil and gas lease.

form and place for public inspection schedules showing all "rates and charges" for any jurisdictional sale and all "classifications, practices, and regulations affecting such rates and charges, together with all contracts which in any manner may affect or relate to such rates, charges, classifications and services."

If the Act were applied to landowners, they would be required publicly to display their lease contracts. Presumably, tacking a lease contract on the wall paper in the front room next to the motto "God Bless Our Happy Home" would be sufficient for an indulgent Commission, although it might be more acceptable to tack it out of the weather in an outhouse or in a shed on the farm more accessible to the public.

Either realizing the absurdity of an open and admitted attempt to apply this crucial section of the Act to landowners and leases or in order to avoid being inundated by hundreds leases requiring the Commission to regulate all leasehold activities and the many inter-related lessor-lessee covenants resulting from the integrated instruments (and probably for both reasons), the Commission entered its ordering paragraph (B) fiat:

> "For regulatory purposes such sales are covered by the filings of the producer-operators and payments made by the producers to the royalty owners should be made as provided by the contractual provisions of each lease, except that in no event should the payment exceed the just and reasonable rates as fixed by the Commission under the Act."[21]

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21 Shell pet., 40a

The rate schedules filed by lessees as independent producers under the Act are contractual agreements made solely between them and a pipeline company, together with all agency authorizations in the case where the lessee acts as selling agent for non-signatory co-owners of the natural gas. The landowners are not parties, signatory or non-signatory, to these contracts or any such agency agreements and are not in any way legally bound by them.[22]

Assuming that the lease is an agreement for the purchase and sale of gas, the lessor is the *seller* and the lessee is the *buyer.*

In order to camouflage the inapplicability of Section 4 of the Act, the Commission had to conceal the fact that regulated rates must be contractual in the first instance, filed by *seller.* This was concealed by administrative fiat eliminating the statutory requirement of a seller filing under the pretense that the lessees' contracts with others, in which lessee is the *seller* is the identical contract under which he is a *buyer* from lessor.

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22 The argument that some "agency" might exist between lessors and lessees (see F.P.C. pet., 9) is specious. How could an agent agree to sell for a price other than agreed upon in the lease contract which is presumed to create the agency? We do not understand the reason for Amoco's reference to a claim of a fiduciary duty with respect to its gaining a higher price for gas (Amoco pet., 4) unless it also is an attempt to infer agency. The reference is obscure, but probably relates to the landowners' position, squarely contrary to that suggested by Amoco, that lessees could not possibly be considered acting as lessor's agent and that Amoco's and Mobil's rates could not possibly be considered as applying to landowners royalty payments in view of their practice of making price concessions in nation-wide settlements as to gas produced by them on Kansas premises in return for higher prices elsewhere in the interest of their stockholders.

As a further cover-up, the Commission found it necessary to ignore even a part of the royalty provisions of the lease relating to quantities produced. Otherwise, it would be readily apparent from the face of the order that the royalty payment was only a cash rental transaction.

This is clearly seen when it is remembered that rental payments are computed upon the entire produced volume, however marketed or used by lessee for its own purposes, and that, on the other hand, the lessee's gas sales contracts which it makes as seller of its own gas cover only the volumes ultimately delivered for resale in interstate commerce to pipeline companies.

The produced volumes used in computing the rental payments frequently are of greater value on a per Mcf. basis because those volumes contain, at that point, gaseous hydrocarbons which are later marketed by lessee to others in liquid state at equivalent per Mcf. prices that are greater than the per Mcf. prices for the volumes ultimately delivered by lessees to pipeline companies. So there is no identity of per Mcf. value either.

Assume a value on the leased premises of 16 cents per Mcf., including the value of liquefiable hydrocarbon content then in gaseous state. The landowners are to be paid based not on such value but on one-eighth of such value, or on the basis of 2 cents per Mcf. Assume, also, that the per Mcf. value of the residue gas finally delivered in interstate commerce by the lessee, after its use of it for other purposes, is 14 cents. If the rental payments are

considered as payments for the sale of gas, the per Mcf. price for the gas "sold" by lessor to lessee is one-eighth of that, or only 2 cents, while the sales price for gas sold by lessee to the pipeline company is 14 cents, or seven (not eight) times greater.

What the Commission did was to ignore that part of the rental computation which refers to the fact that the landowner is "paid", under a sales theory, for *all* of the gas produced and marketed or used. It pretended that the royalty is "paid" for only *one-eighth of the natural gas.*

The Commission disregarded this lack of identity of activities, quantities and values in stating that "the interests of the royalty owners are covered by the filings of producer-operators . . ."[23]

Under the Commission's order, it makes no difference what the percentage applied might be. If the percentage is 1/8th, the "price" due the landowner (assuming a value on the leased premises value of 12 cents) is 1.5 cents per Mcf.; if the percentage is 3/16th, the "price" is 2.25 cents per Mcf. Under the Commission's order, each is equally a fair and reasonable "rate" under the Natural Gas Act.

It is apparent from the above that, although the order was written so as to have general application, the order was effectively designed to protect only those lessees, petitioners here, who talked the Commission into entering it.

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23 Shell pet., 40a

But more to the point, the above demonstrates beyond a doubt that it takes a lot of verbal shenanigans coupled with unspoken and concealed legerdemain to try to make it appear that the Natural Gas Act can be adapted as a rent-control measure. If this seems to be a harsh criticism, Commissioner Carver said the same thing in different words. He described the order of his colleagues as a "bootstrap conclusion" which "taxes credulity to the breaking point"[24] made "with only the most general reference to statutory criteria and in reliance on precedents that have no direct bearing on the present issues.[25]

He also stated:[26]

> "In order to support a finding that royalty owners have participated in a sale of natural gas, it is essential that some specific operative act, some definite transaction, be identified as having the legally accepted characteristics of a 'sale.' * * *
>
> "We don't know the majority's theory in this respect, because the issue, and indeed the whole matter of how a sale occurs, is evaded by a forensic *tour de force.* The fact of a sale is declared, rather than demonstrated by any acceptable rationale. And we are told that technical concepts of law have no bearing since this Commission is not bound 'by Hornbook definitions or local decisions not applicable to the Natural Gas Act.' There is little doubt that this is an accepted benchmark in rule case law, * * *

24 Shell pet., 46a
25 Shell pet., 45a
26 Shell pet., 47a-48a

"But we are not at liberty to enlarge that principle into an unrestricted license to snatch our own definitions out of the cosmos, hand-tailored to fit the case, any more than problems of construction can be swept away by denigrating reference to established legal concepts. The precise task at hand is to give meaning and effect to the 'sale for resale' criterion of jurisdiction and to measure the concept of a mineral lease against that standard. Absent some clear indication that Congress meant to abandon and deny accepted principles of property and contract law, they should be used as interpretive guideposts and aids to construction.

* * *"

This Court as early as 1871 considered and defined the word "sale" and quoted a learned author as saying, "If anyone of the ingredients be wanting, there is no sale." *Butler v. Thompson*, 92 U.S. 684 at 685 (1876). Here all ingredients are lacking.

Who is the seller? Under the Commission's order it is simply asserted that landowner is the seller. But the Commission does not consider him a seller under Section 7 of the Act requiring him to receive a certifcate authorizing leasing of land by him. Nor is landowner considered a seller under Sections 4 and 5 of the Act assuring reasonable rates after giving consideration to the possible economic effect of regulation upon him as seller.

The cynicism with which the oil companies approach the entire matter is demonstrated by Mobil's reference to the royalty payments as a "windfall". (Mobil Pet.,

26) This is reminiscent of the following testimony before the F.P.C. in an area rate case drawn to the writer's attention by a friend:

> "Q. Do you consider that the bonuses and royalties paid by the producer to the lessor or landowner constitute economic rent to the landowner?
>
> "A. (Dr. Kahn) Yes.
>
> "Q. Does that mean there should be no compensation to the landowner?
>
> "A. Do you want my opinion or — it is a little hard to know how to answer this. In my judgment there should be *no compensation* to the landowner, or his compensation *should be taken away from him by the government.*" [Emphasis added]. (Transcript of Proceedings in South Louisiana Area Rate Proceedings, p. 13, 267)

How depriving landowners of this "windfall", the only compensation landowners receive by reason of *any* use of their land during production activities, will enhance the supply of natural gas (short of prior socialistic confiscation by Congress of interests in land) is nowhere explained by Mobil, although it and other petitioners pretend to be concerned about the supply of natural gas.

Who is the buyer? Under the order, the filings of the producers control. Under those filings, the only buyers are the pipelines. But jurisdiction is urged by reason of the royalty provisions of the lease, which, construed as a sales agreement, makes lessee the buyer. In reliance upon the lease agreements the lessees now seek, as buyers, retroactively to recover refunds and place limitations on

the amount they were contractually required to pay and did pay.

What is the contract of sale? Although Section 4 of the Act, as above stated, requires filing of all classifications, practices and regulations affecting rates and charges, together with all contracts which in any manner affect or relate to the same, the Commission and the proponents of what is essentially rent control are required by their "sales" theory to ignore all provisions of a fully integrated lease instrument except for the single word "value" or its equivalent.

What is the place of delivery? The leases do not, of course, provide for a place of delivery, since nothing is sold and no delivery is contemplated. There is no commodity to be delivered. All of the real, honest-to-goodness contracts for the first sale of 100% of the gas contain this ingredient.

The next question is, what is the price?

As pointed out above, lessees here have claimed that royalties should be computed in amounts resulting in payments ranging from less than a half-cent per Mcf. produced beginning in 1954 to over two cents during later periods, with the landowners claiming that payments should have been consistently made during later periods at a little over two cents per Mcf., and resist lessee's claims for refunds for alleged overpayments during earlier monthly periods.

The higher per Mcf. prices in the real gas purchase contracts in the range up to over sixteen cents are other

than the per Mcf. figures on which payments have been made to landowners, other than those which lessees claim they should have made, other than those which landowners claim, and other than those applicable on the leased premises on anybody's theory.

All of these anomolies result from trying to make a sale out of a rental transaction. The values of less than one-half to two cents per Mcf. on the leased premises constitute the agreed-upon use-value of the land while used for gas production purposes. They are paid as rental in the same manner as in other percentage leases. None of the indices of sale of a commodity are needed or present. These are the only rentals which lessor receives for all activities and uses during production activities. The use value of the land is continually reduced as production continues, resulting in the public policy of recognition of such deteriorating value through depletion allowance in the absence of other provisions for depreciation on unimproved land.

On the other hand, the higher values set forth in the contracts between the lessees and the pipeline companies are intended as payment for an actual sale of natural gas, with all indices of sale being present.

The Natural Gas Act obviously was not intended by Congress to be a rent-control measure to regulate rents under types of ordinary leases known to it to exist long before the Act was passed. It was designed to regulate "sales", a legal concept equally well known at the time, none of the ingredients of which we have present.

**There Is No Conflict of Decisions**

The *Rayne Field*,[27] *Ship Shoal*,[28] *and Bastian Bay*[29] cases, upon which petitioners rely, all admittedly involved actual and not pretended sales. All of the ingredients of sale above mentioned were admittedly present, including computed quantities but the lessees claimed that the economic effect of a conventional sale of gas could be avoided by making leases, rather than natural gas, the *subject* of an *admitted sale*. The court found that this was just a dodge. However viewed, the lessee was an admitted selier. The ownership of *all* of the natural gas came along with the lease sale. The pipeline became the owner of all of the gas, as it would under the conventional sale of natural gas. The indicia of sale including quantities under developed leases were identical whether the subject matter sold was described as a lease or as natural gas. Indeed, the cases are directly contrary to petitioners' position here, because they clearly show that all of the indicia of natural gas ownership produced under a lease is in the lease owner and not in the landowner.

*Rayne Field* certainly was not intended by this Court as a license to ignore traditional rules of contract law. In that case, the new arrangement was carefully drawn in such a way that it would result in virtually the same economic effect as traditional arrangements. Only the form was changed. On the other hand, the arrangement here is a traditional one — a rental arrangement that existed

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27 *United Gas Improvement Company v. Continental Oil Co.*, 381 U.S. 392 (1965)

28 *Continental Oil Co. v. FPC*, 5 Cir., 370 F.2d 57 (1966)

29 *FPC v. Pan Am Petroleum Corp.*, 381 U.S. 762 (1965)

long before the Natural Gas Act. No change has been made with the view of changing the status of anyone or any transaction.

That royalties paid pursuant to an oil and gas lease have never been payments for the sale of gas results not from technical rules governing such transactions, but from the physical and economic facts surrounding the lease transaction. The proponents of F.P.C. jurisdiction in this case do not ignore technical rules of state law to give effect to an underlying economic reality. They turn *Rayne Field* upside down and, inventing a new rule of law, use *Rayne Field* to destroy the underlying economic reality. In *Rayne Field,* the lessees were told that the clever use of words would not prevail over the facts. But they are back at it again, attempting the same thing. By the use of clever words, they attempt to free themselves from the facts.

As stated by the Court of Appeals below:

"When we came to an ordinary lease by the landowner to the producer there is neither a 'customary' sale in interstate commerce nor its equivalent in economic effect. Such a lease is a transaction that is itself customary and conventional, but one that precedes the 'conventional' sales in interstate commerce with which Congress was concerned, indeed even precedes the 'production and gathering' which § 1(b) visualized as preceding the sale in interstate commerce over which jurisdiction was being established.

"Turning to the 'significant and determinative economic facts,' basically the significant fact for a sale

in interstate commerce is interstate movement either by the seller, prior to or in connection with the sale, or by the purchaser, typically an interstate pipeline company, subsequent to or in connection with the sale. In the case of a typical oil and gas lease, there is no such interstate movement by either the transferor or transferee." (Shell pet., 14a-15a)

Shell relies on a theory that no sale exists but that the attempted expansion of jurisdiction might be justified on a burden-on-commerce theory.

Merely because royalty payments might affect the ultimate price to the consumer is not a ground for regulating them. Every expense of a natural gas company has that effect.

Numerous substantial items of cost are incurred by natural gas companies. Among other things, companies buy pipe, purchase leases, pay bonuses, hire well-servicing units, hire drilling equipment and pay for pipeline right-of-way. Each of these items represents a cost which could perhaps raise the price of gas to the consumer. As a result, if desirability of regulation alone were sufficient to create the power to regulate, the Commission should have power to regulate each of these items. But, of course, it has no such power. The provisions of 15 U.S.C. 717(b) define the limits of the Commission's power. Those limits have nothing to do with what is desirable. Instead, they depend upon whether the person sought to be regulated is engaged in the business of selling natural gas. Unless Congress has constitutionally delegated to that administrative agency

the power to regulate the particular transaction, the administrative agency has no such power. *Federal Power Commission v. Panhandle Eastern Pipeline Company,* 337 U.S. 498 (1949). Congress has not seen fit to expand the Commission's jurisdiction.

## CONCLUSION

As we pointed out to the Court below, one is reminded of the medieval inn-keeper. If the guest was too long for the bed, his feet were chopped off; if too short, he was put on the rack and stretched. A few guests died that way, but they always fit the bed. A similar operation was performed here both on landowners and leases, all in an attempt to avoid judicial determination of questions of local import.

The careful decision of the Court of appeals is correct and faithful to all pronouncements of this Court. The petitions for writ of certiorari should be denied.

Respectfully submitted,

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